Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Vargas	Analyst:	Roger Lackey	Bill Number:	AB 2562
Related Bills:	See Legislative History	Telephone:	845-3627	Introduced Date:	02-21-2002
		Attorney:	Patrick Kusiak	Sponsor:	

SUBJECT: Enterprise Zones/Authorizes Transfer of Credits

SUMMARY

This bill would:

- allow a taxpayer in an enterprise zone (EZ) to transfer its credits or credit carryovers to another taxpayer under specified circumstances.
- make certain legislative declarations and establish a disaster loan guarantee program for the border development zone. These provisions do not impact the department and are not discussed in this analysis.

PURPOSE OF THE BILL

It appears the intent of the credit transfer provision in this bill is to allow taxpayers to maximize the use of EZ credits by allowing the credits to be transferred to another taxpayer.

EFFECTIVE/OPERATIVE DATE

As an urgency statute, this bill would be effective immediately and operative for taxable years beginning on or after January 1, 2002.

POSITION

Pending.

Summary of Suggested Amendments

Department staff is available to assist the author in resolving the implementation considerations and policy considerations addressed in this analysis.

Board Position:			Department Director	Date
______ S	______ NA	______ NP		
______ SA	______ O	______ NAR	Alan Hunter for GHG	04/12/02
______ N	______ OUA	__X__ PENDING		

ANALYSIS

FEDERAL/STATE LAW

Under existing state and federal laws, generally tax credits may be claimed only by the taxpayer that incurred the credit-related expense. In the case of the low-income housing credit, if a property is acquired during the credit period, the credit may be transferred to the acquiring taxpayer. In addition, for state purposes, a specific statutory authorization permits the low-income housing credit to be transferred between wholly-owned affiliated corporations.

Existing federal law provides special tax incentives for empowerment zones and enterprise communities to provide economic revitalization of distressed urban and rural areas.

Under the Government Code, existing state law allows the governing body of a city or county to apply for designation as an enterprise zone. Using specified criteria, the Technology and Trade and Commerce Agency (TTCA) designates enterprise zones from the applications received from the governing bodies. Enterprise zones are designated for 15 years (except enterprise zones meeting certain criteria may be extended to 20 years), and TTCA is authorized to designate 42 enterprise zones under current law (39 currently are designated).

Under the Revenue and Taxation Code, existing state law provides special tax incentives for taxpayers conducting business activities within an enterprise zone. These incentives include a sales or use tax credit, hiring credit, business expense deduction, special net operating loss treatment, and net interest deduction. In addition, a wage credit may be claimed by specified employees of businesses operating in an enterprise zone.

For businesses operating inside and outside an economic development area, the amount of credit or net operating loss deduction that may be claimed is limited by the amount of tax on income attributable to the economic development area. Income is first apportioned to California using the same formula as that used by all businesses that operate inside and outside the state (property, payroll, a double-weighted sales factor). This income is further apportioned to the economic development area using a two-factor formula based on the property and payroll of the business.

The credits and deductions generated in the EZ may only be applied against income generated by the taxpayer in the EZ.

THIS BILL

This bill would allow a taxpayer that qualifies for a credit while operating a business in an enterprise zone to transfer that credit or a subsequent carryover of that credit to any other taxpayer in this state.

This bill would require that an agreement to provide financing to the transferor by the transferee be made for the credit to be eligible for transfer.

This bill would limit the amount of the credit or credit carryover that could be used by the transferee. The transferee could only use the same amount of credit that would be otherwise available to the transferor if the transferor had used the credit. For example, if the transferor had a tax liability of $1,000 for a taxable year, and had not transferred the credit, the transferor could have used a maximum of $1,000 of its credit or credit carryover. Therefore, the transferee would be limited to using the same amount of credit as the transferor.

IMPLEMENTATION CONSIDERATIONS

This bill would raise the following implementation concerns:

1. Since the credit may be transferred only by a lending agreement, it is unclear how the author wants the transfer to be treated for tax purposes. The lending agreement may result in the receipt of fees or the accrual of interest by the transferor that could be recognized as income. The receipt of any income by the transferor would in effect mean the credits were being sold.

2. The term “used” is undefined. It appears to be in the context of the transferee applying the credit against its tax liability, but without a clear meaning it could be misconstrued. For example, the credit may be interpreted as “used” if the transferee transferred the credit to yet another taxpayer rather than claimed the transferred credit against its own tax liability.

3. This bill would go into effect upon enactment and apply to taxable years beginning on and after January 1, 2002, which would require that the department create a new program immediately upon enactment to track the transfer of credits. Without a clear understanding of how the credit would be transferred, and any limitations on the transfer of the credits, developing an effective method of tracking the transferred credits would be extremely difficult.

   Further, if no program is available to track the transfer of credits, issues may result for the taxpayer and the department. For example, if the transferee does not operate in the EZ, staff may automatically assess the taxpayer either during return processing or during a review (pre-audit) of the return disallowing the credit (statutory adjustment). On the transferor side, the transferor may erroneously claim the credit that was transferred, but the department would not have information that the credit was transferred and thus inappropriately claimed. The prior concern would be magnified if there were no limitation on the number of times the credit may be transferred.

4. This bill leaves unclear whether the transferee taxpayer can use the transferred credit in the same taxable year as the transferor earned the credit or whether the transferee only can use the transferred credit in the taxable year in which the credit is transferred under the bill's provisions (and succeeding taxable years if limited).

5. The bill does not address whether the entire credit or only portions of the credit may be transferred. If portions of the credit may be transferred, the bill does not address whether or how one credit may be divided among multiple transferees. In addition, the bill is silent on how the "use" limitation would be applied in such a situation.

6. The bill would not allow the credit used by the transferee to exceed the amount of the credit that would be otherwise available to the transferor. It is unclear if that means the transferee is limited to using whatever the transferor could apply against its own tax liability for that taxable year, if it still had the credit, or whether it is referring to the total amount of credit carryover the taxpayer held. If it is the former, and if the transferor had zero tax liability for the taxable year, the transferee would be unable to utilize any of the credit it had acquired. Moreover, if the former interpretation reflects the author's intent, then the transferor would have to inform the transferee each taxable year of what it could have used if it still retained the credit, and the transferee would then claim that amount. If upon subsequent audit the amount the transferor could have used changes, it is further unclear whether the department would be authorized to change the transferee's tax liability to reflect the change in the transferor's tax liability. In any event, the department would need to be specifically authorized to disclose the necessary confidential tax information of the transferor to the transferee if such an adjustment were proposed.

In addition, current law allows only the transferor to use its EZ credit to the extent allowed by its EZ tax. This bill does not address whether the transferee also is subject to this limitation. If so, then the transferable credit is only eligible for those doing business in the same enterprise zone. If the amount of credit claimed by the transferor were not limited by zone tax, then the credit would be used significantly faster than was intended (escalation of revenue benefits) and would thwart one of the main principles of the EZ legislation–that the credits would only offset business income/tax on income generated in that same area.

7. It is unclear what would happen if a taxpayer transfers a credit and the credit is partially or completely disallowed in a subsequent audit. The bill should clarify the department's authority to adjust the tax liability of the transferee and reclaim the credit amount. Moreover, since there may be occasion where the department's audit of the transferor taxpayer's return may occur after normal expiration of the statute of limitations (i.e., under a waiver), it might become necessary for the department to request waiver of the transferee's statute of limitations to prevent the department from being foreclosed from adjusting the transferee's tax liability when the department determines that part or all of the claimed credit should never have been allowed. Further, the department would need to be specifically authorized to disclose the necessary confidential tax information of the transferor to the transferee if such a situation arose.

   Alternatively, if the claimed credit of the transferor is disallowed only in part, it is unclear how this disallowance would be allocated between the transferor and the transferee, especially if the statute of limitations has expired for one, but not both, of the affected taxpayers.

   Due to the complexity of a transfer, the taxpayer involved in the transfer of credits should be required to maintain records to support the credit calculation in the event of an audit. The transfer of a credit does not eliminate the transferor's exposure to an audit inquiry or eliminate their need to support the credit calculation.

8. It's unclear if a transferee can become a transferor. That is, can a taxpayer who has obtained the EZ credits from one taxpayer transfer those credits on to another taxpayer, and so on. It is also unclear if there are any limitations on the number of times a credit can be transferred.

   Since it is unclear how many different transferees a transferor can divide a credit between ,and with the lack of definitions in this bill, a taxpayer could amass a significant amount of credits that could be transferred to a large number of taxpayers with little or no ability to verify the legitimacy of the transferred credits.

9. This bill specifies that any credit can be transferred to any other taxpayer in "the state." "In the state" is ambiguous. If the credit is to be transferred to another California taxpayer "the state" should be "this state." Alternatively, if the provision is intended to limit the transfer to a taxpayer who is domiciled or resident in this state only, then it may pose constitutional discrimination issues with respect to non-resident and/or non-domiciled taxpayers who have California source income subject to tax.

LEGISLATIVE HISTORY

AB 1230 (Pacheco 1999/2000) would have allowed a taxpayer that claims the research expenses credit to transfer the credit to another taxpayer. AB 1230 failed to pass out of the Assembly Revenue and Taxation Committee.

OTHER STATES' INFORMATION

Currently, 29 other states have economic development areas that provide similar tax related incentives to those provided by California's economic development areas. *Florida, Illinois, Massachusetts*, *Michigan*, and *New York* tax laws were reviewed to determine if any of these states had laws permitting the transfer of economic development area related credit. Based on the information available, none of these states allow credits accrued in the economic development areas to be transferred to another taxpayer.

FISCAL IMPACT

Once the implementation and policy considerations are resolved, implementing this bill would require some changes to existing tax forms and instructions and information systems, which could be accomplished during the department's normal annual update.

ECONOMIC IMPACT

Revenue Estimate

No revenue estimates can be developed at this time.

It is not possible to predict taxpayers' response to the ability to transfer credits since there are unresolved implementation concerns. For informational purposes only, based on available 1999 tax year data, total unused Enterprise Zone tax credits had a reported value of:

Three EZs bordering Mexico (cited in the bill)	$2 million
All Enterprise Zones	$121 million

ARGUMENTS/POLICY CONCERNS

Under state law, only the low-income housing credit contains a provision to allow the credit to be assigned and only under narrow circumstances. The transfer of that credit to the purchaser of the property or between affiliated corporations may occur if the affiliation between the entities consists of 100% ownership. Conversely, this bill would allow the credit to be transferred on an unrestricted basis since the bill does not restrict the class of eligible transferees, thereby creating a precedent allowing a credit to be transferred from the taxpayer that incurred the expenses to a taxpayer that assumes no risk associated with the underlying transaction resulting in the credit. In addition, the credit would be transferable regardless of whether the transferee is doing business in an EZ.

Further, this bill would create a system of "California tax benefit transfers" similar to the old federal safe harbor leasing regime. However, tax credits transferable under federal safe harbor leasing rules were limited to tax credits for the purchase of certain property and the transfer was accomplished by a nominal sale-leaseback of that property that thereby defined the tax consequences of the tax benefit transfer as between the parties. The EZ tax credits are based on various expenses. In the absence of clarification, disputes may arise between taxpayers and the department as to the proper tax treatment of consideration paid in connection with the transfer of a credit under this bill.

In the 1999/2000 legislative session, AB 1903 (Lowenthal) was introduced that would have allowed the low-income housing credit to be allocated in accordance with a partnership agreement, without regard to the substantial economic effect of such an allocation. This bill was viewed as tantamount to allowing the ‘transfer’ of the low-income housing tax credit. The Governor vetoed this legislation due to the potential for abuse.

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